



# STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

# DRAFT

Date:	04/01/13	Bill No:	<a href="#">Senate Bill 235</a>
Tax Program:	Sales and Use Tax	Author:	Wyland
Sponsor:	Author	Code Sections:	RTC 6377.1
Related Bills:	SB 376 (Correa) SB 412 (Knight) AB 486 (Mullin) AB 653 (Perez, V.) AB 1326 (Gorell)	Effective Date:	Upon enactment, but operative 01/01/14

*This analysis only addresses the portion of the bill that impacts the Board of Equalization (BOE).*

## BILL SUMMARY

Beginning January 1, 2014, this bill provides manufacturers and their affiliates a 3.9375% state sales and use tax exemption for their purchases of qualifying tangible personal property.

## Summary of Amendments

Since the previous analysis, this bill was amended to add provisions that impact the Franchise Tax Board (FTB) and are not discussed in this analysis.

## ANALYSIS

### CURRENT LAW

Except where the law provides a specific exemption or exclusion, California's Sales and Use Tax Law<sup>1</sup> imposes the sales tax on all retailers for the privilege of selling tangible personal property at retail in this state or the use tax on the storage, use, or other consumption in this state of tangible personal property purchased from a retailer.

Generally, sales or use tax applies to the sale or purchase of tangible personal property to persons who use the property to manufacture, produce or process other tangible personal property. A manufacturer's taxable purchases include machines, tools, furniture, forklifts, generators, and office equipment.

Conversely, tax does not apply to sales of tangible personal property when the purchasers physically incorporate that property into the manufactured article to be sold. For example, no tax applies to a manufacturer's raw material purchases when, prior to making a taxable use, they become an ingredient or component part of the manufactured article to be resold.

**California Alternative Energy and Advanced Transportation Financing Authority (CAEATFA).** Existing law<sup>2</sup> contains a specific sales and use tax exclusion<sup>3</sup> for tangible

<sup>1</sup> Part 1 of Division 2 (commencing with Section 6001) of the Revenue and Taxation Code (RTC).

<sup>2</sup> RTC Section 6010.8.

<sup>3</sup> An "exclusion" means the transfer of the property is neither a "sale" nor a "purchase" and is therefore excluded from the application of the sales and use tax. An "exemption" involves a retail sale that, absent an exemption in law, would otherwise be subject to the tax.

*This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the BOE's formal position.*

personal property purchased for certain approved manufacturing projects. In 2010, legislation<sup>4</sup> authorized the CAEATFA to approve sales and use tax exclusions for tangible personal property utilized for the design, manufacture, production, or assembly of advanced transportation technologies or alternative energy source products, components or systems. In 2012, legislation<sup>5</sup> was enacted to authorize CAEATFA to approve sales and use tax exclusions related to advanced manufacturing projects until July 1, 2016. The law<sup>6</sup> provides a \$100 million cap for these exclusions.

CAEATFA's approval of these exclusions is based on whether the project results in a net benefit to the State, with consideration to both fiscal and environmental benefits.

**California's sales and use tax rates.** Effective January 1, 2013, California imposes a statewide 7.5% sales and use tax on tangible personal property sales and purchases. The table below shows California's various sales and use tax rate components (the table excludes voter-approved city and county district taxes):

Rate	Jurisdiction	Purpose/Authority
3.9375%	State (General Fund)	State general purposes (Revenue and Taxation Code (RTC) Sections 6051, 6051.3, 6201, and 6201.3)
1.0625%	Local Revenue Fund 2011	Realignment of local public safety services (RTC Sections 6051.15 and 6201.15)
0.25%	State (Fiscal Recovery Fund)	Repayment of the Economic Recovery Bonds (RTC Sections 6051.5 and 6201.5)
0.25%	State (Education Protection Account)	Schools and community college funding (Section 36, Article XIII, State Constitution)
0.50%	State (Local Revenue Fund)	Local governments to fund health and welfare programs (RTC Sections 6051.2 and 6201.2)
0.50%	State (Local Public Safety Fund)	Local governments to fund public safety services (Section 35, Article XIII, State Constitution)
1.00%	Local (City/County) 0.75% City and County 0.25% County	City and county general operations (RTC Section 7203.1, operative 7/1/04); Dedicated to county transportation purposes
7.50%	Total Statewide Rate	

### PROPOSED LAW

Beginning January 1, 2014, this bill provides a 3.9375% state sales and use tax exemption for a "qualified person's" purchase of:

- Tangible personal property to be used 50% or more in manufacturing, processing, refining, fabricating, or recycling of property (i.e., machinery, equipment, parts, belts, shafts, computers, software, pollution control equipment, fuels, buildings and foundations), as specified.
- Tangible personal property purchased by a contractor, as specified, for use in the performance of a qualified person's construction contract. The qualified person must

<sup>4</sup> SB 71 (Ch. 10, Stats. 2010, effective March 24, 2010).

<sup>5</sup> SB 1128 (Ch. 677, Stats. 2011, effective January 1, 2013).

<sup>6</sup> Public Resources Code Section 26011.8.

*This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the BOE's formal position.*

use the property, however, as an integral part of any manufacturing, processing, refining, fabricating, or recycling process or as a research or storage facility in connection with the manufacturing process.

- Tangible personal property to be used 50% or more in research and development.

This bill defines “qualified person” as either:

- A trade or business that is engaged in manufacturing activities, as described in the North American Industry Classification System (NAICS) (2007 edition) codes 3111 to 3399, inclusive, or
- A qualified person’s affiliate, if the affiliate is a member of that person’s unitary group, as specified.

The bill defines “fabricating,” “manufacturing,” “primarily,” “process,” “processing,” “refining,” “research and development,” and “useful life.” The bill also specifies the tangible personal property included or excluded from the partial exemption.

The proposed partial exemption excludes:

- Consumables with less than a one year useful life, except fuels,
- Furniture, inventory, equipment used in the extraction process or equipment used to store finished products that have completed the manufacturing process, and
- Tangible personal property primarily used in administration, general management, or marketing.

The bill only exempts qualifying sales and purchases from the state’s 3.9375% General Fund sales and use tax rate.

### BACKGROUND

For a ten-year period ending December 31, 2003, the law provided new manufacturers with a state General Fund sales and use tax exemption on their purchases of specified manufacturing equipment. Also, the law provided manufacturers income and corporation tax credits (MIC) of 6% for similar equipment placed in service in California. Similar to the exemption proposed in this bill, the partial exemption and credit related to equipment used primarily for manufacturing, refining, processing, fabricating or recycling. New manufacturers could claim the partial exemption or the MIC. However, existing manufacturers could only claim the MIC.

This partial exemption and MIC contained a conditional sunset date. The law required these provisions to sunset when manufacturing employment,<sup>7</sup> less aerospace employment, failed to exceed January 1, 1994 manufacturing employment by more than 100,000. On January 1, 2003, the employment figures were less than the 1994 number by over 10,000. Therefore, the partial exemption and MIC sunset at the end of 2003.

**Legislative History.** Since then, numerous bills have been introduced to reinstate, expand, or modify the exemption and/or MIC, but all failed to pass. Bills introduced during the last two Legislative sessions that exempted similar purchases from sales and use tax include:

---

<sup>7</sup> As determined by the Employment Development Department.

Bill No.	Session	Author	Proposed Exemption
ABx1 40	2011-12	Allen	3.9375% exemption for new businesses and 3% for existing businesses engaged in manufacturing, software production, biotechnology research and development, and renewable power generation facilities.
AB 103	2011-12	Budget Committee	5% exemption for new manufacturers and software producers, and 1% for existing manufacturers and software producers.
AB 218	2011-12	Wieckowski	5.25% exemption for manufacturers and software producers.
AB 303	2011-12	Knight	5% exemption for new manufacturers.
AB 979	2011-12	Silva	5% exemption for manufacturers and software producers and affiliates.
AB 1057	2011-12	Olsen	5% exemption for manufacturing, research and development, and air pollution mitigation by manufacturers and affiliates.
SB 116	2011-12	Dutton	Same as ABx1 40 above.
SB 395	2011-12	Dutton	5% exemption for manufacturing and software production.
AB 1911	2011-12	Donnelly	3.9375% exemption for manufacturing and software production.
AB 1972	2011-12	Huber	Full exemption for manufacturing, software production, biotechnology research and development, and renewable power generation facilities.
SB 686	2011-12	Padilla	Full exemption for biotechnology manufacturing and research and development activities.
AB 810 and AB 829	2009-10	Caballero	5% exemption for qualifying tangible personal property, and 6% exemption for sustainable development equipment investments by manufacturing and software production.
AB 1719	2009-10	Harkey	6% exemption for manufacturing.
AB 1812	2009-10	Silva	6% exemption for manufacturing and software production.
AB 2280	2009-10	Miller	Full exemption for manufacturing.
SB 1053	2009-10	Runner	6% exemption for manufacturing and software publishing and their affiliates.
SBx6 18	2009-10	Steinberg & Alquist	6% exemption for specific manufacturing and software production activities.
SBx6 8 & SBx6 44	2009-10	Dutton	6% exemption for manufacturers and software publishers and affiliates.

## COMMENTS

- 1. Sponsor and Purpose.** According to the author, this bill is intended to encourage job creation and economic growth in California's manufacturing sector by providing a state sales and use tax exemption for equipment used in the manufacturing process.

---

*This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the BOE's formal position.*

2. **The April 1, 2013 amendments** add provisions that fall under the purview of the FTB.
3. **Qualified persons need not be *primarily* engaged in the businesses described in NAICS codes 3111 to 3399 pertaining to manufacturers.** We recommend the bill specify that a qualified person's activities be *primarily* those described in the referenced NAICS codes. This issue generated a dispute when the BOE and FTB administered the previous MIC. In an FTB appeal, the BOE ruled that a grocery store's meat processing and bakery operations constituted "manufacturing." The BOE approved the grocery store's claimed MIC for its associated equipment investments despite that the grocery store was not primarily engaged in one of the identified NAICS codes. Without more specificity in this bill, the state's revenue losses could significantly exceed revenue losses anticipated or identified in this analysis. Our suggested amendment is identified on page 9 as "Amendment 1."
4. **Affiliates' purchases also qualify for the proposed exemption.** In addition to the entities described previously, these establishments' affiliate purchases qualify for the exemption.<sup>8</sup> As proposed, the law does not require that the affiliates be engaged in particular activities. Instead, their purchases of qualifying tangible personal property need only be for use in a manner described in the bill. For example, a television manufacturer's affiliate may be primarily engaged in recycling. All the affiliate's equipment purchases for recycling would qualify for the proposed exemption, even if they are unrelated to television manufacturing, i.e., the activity which makes both persons "qualified persons." This is true whether or not the manufacturer operates primarily outside this state. The original manufacturing exemption discussed above did not include this provision. Potentially, this provision adds a new level of complexity for tax administration purposes, and results in additional revenue losses not captured in this analysis.
5. **Proposed exemption differs from previous exemption.** As drafted, this bill does not exempt tangible personal property purchased to measure or test qualifying tangible personal property. These purchases by qualified manufacturing establishments were eligible for the previous partial exemption.
6. **Partial exemptions complicate administration of the tax.** Currently, most sales and use tax exemptions apply to the total applicable sales and use tax. However, California law contains five partial exemptions, currently at a 5.5%<sup>9</sup> rate:
  - (1) Farm equipment and machinery,
  - (2) Diesel fuel used for farming and food processing,
  - (3) Teleproduction and postproduction equipment,
  - (4) Timber harvesting equipment and machinery, and
  - (5) Racehorse breeding stock.

These partial tax exemptions complicate retailers' return preparation and return processing. Return errors occur frequently with claimed partial exemptions. Accordingly, the BOE's return processing workload increases.

---

<sup>8</sup> Those that are members of the entity's unitary group for which a combined report is required under Article 1 (commencing with Section 25101) of Chapter 17 of Part 11 of the RTC.

<sup>9</sup> 3.9375% General Fund, 1.0625% Local Revenue Fund 2011, 0.25% Fiscal Recovery Fund, and 0.25% Education Protection Account.

Also, this bill proposes a new 3.9375% exemption rate. This requires a sales and use tax return revision with a new, separate return computation. If enacted, some retailers may be required to segregate the 3.9375% exempt sales, the 5.50% exempt sales, fully exempted sales (e.g., a resale sale or interstate commerce sale), and fully taxable sales. This adds a new level of complexity, and potentially increases tax reporting errors. Accordingly, the BOE's tax administration functions and retailers' reporting obligations become more complicated.

7. **The term “property” needs clarification.** The bill exempts a qualified person's “property” purchased for use in manufacturing, fabrication, processing, etc. Manufactured “property” is generally construed to mean the traditional manufacturing of tangible items, not the creation of intangibles or the provision of services and utilities. However, the bill does not expressly limit the term to tangible personal property purchased for use in manufacturing or fabricating. Taxpayers could assert that the bill includes the creation of intangible property or the provision of services and utilities. To avoid any unintended consequence, we recommend the term “property” be replaced with “tangible personal property.” Suggested amendments are shown on page 9 as Amendments 2, 3, and 4.
8. **Technical issue.** Proposed Section 6377(f) (page 8, lines 7-17) exempts specified leases for a six-year period. This limitation mirrors a similar provision contained in the partial exemption for manufacturing equipment purchases the BOE previously administered. However, the former partial exemption applied only to *new* manufacturers. Since this bill applies to all qualifying persons, it appears the bill's six-year limitation for leases is unnecessary and perhaps should be stricken. Otherwise, long-term leases of qualifying tangible personal property will not receive the same benefit as purchases of the same qualifying property enjoy under the bill.
9. **Related legislation.** Similar bills introduced this year include:
  - **SB 376 (Correa)** – beginning January 1, 2017, provides manufacturers, software publishers, and their affiliates a 6.5% exemption for their qualifying tangible personal property. Provides an income tax credit for tax paid on similar purchases beginning January 1, 2014 through January 1, 2017.
  - **SB 412 (Knight)** – provides aerospace products and parts manufacturers a 3.9375% exemption for their qualifying tangible personal property purchases.
  - **AB 486 (Mullin)** – provides manufacturers, software producers, biotechnology and other research and development entities, and their affiliates a 5.25% exemption for their qualifying tangible personal property purchases.
  - **AB 653 (V. Perez)** – provides manufacturers, software publishers, biotechnology research entities, as well as specified power generator facilities and their affiliates a state and local exemption for their qualifying tangible personal property purchases.
  - **AB 1326 (Gorell)** – provides unmanned aerial vehicle manufacturers a state and local exemption for their qualifying tangible personal property purchases.

**COST ESTIMATE**

A cost estimate is pending to determine costs to reprogram for the partial exemption, revise and process returns, notify retailers, audit claimed exemptions, and answer inquiries from taxpayers and the general public.

**REVENUE ESTIMATE****BACKGROUND, METHODOLOGY, AND ASSUMPTIONS**

**NAICS 31-33 (Manufacturing).** The United States Census Bureau's *Annual Survey of Manufacturers* (ASM) reports California manufacturing capital expenditures data (machines and equipment, buildings, fuels). In fiscal year (FY) 2010-11, California manufacturers' capital expenditures amounted to an estimated \$12.5 billion. We assume this amount includes manufacturers' research and development-related capital expenditures.

The partial sales and use tax exemption becomes operative January 1, 2014. To forecast expenditures from the 2010-11 data described previously, we used a national economic forecasting firm's (IHS Global Insight) most recent business equipment investment forecast. The estimated expenditures are as follows:

<b><u>Manufacturing Capital Expenditures - California</u></b>			
<i>(In billions)</i>			
	FY 2013-14	FY 2014-15	FY 2015-16
NAICS 31-33	\$15.3	\$16.3	\$17.4

**REVENUE SUMMARY**

The annual revenue loss from exempting qualifying purchases used in manufacturing (NAICS 31-33) from the 3.9375% sales and use tax amounts to:

<b><u>Sales &amp; Use Tax Loss</u></b>			
<i>(In millions)</i>			
6 month impact			
	FY 2013-14	FY 2014-15	FY 2015-16
State General Fund 3.94%	\$302	\$642	\$686

**Qualifying Remarks.** The revenue estimate is understated to the extent that the bill (1) does not limit the proposed partial exemption to establishments *primarily* engaged in manufacturing, software publishing, and qualifying R&D, and (2) the proposed partial exemption applies to affiliate purchases, as defined. Our estimate is based on those establishments that are *primarily* engaged in the qualifying activities. For the affiliate purchases, we do not have information related to the revenue loss associated with these purchases.

In addition, the revenue estimate is overstated to the extent that it does not account for manufacturing-related sales and use tax exclusions authorized by CAEATFA. The 2009 legislation has resulted in sales and use tax revenue losses of approximately \$37 million in 2010, \$4.7 million in 2011, and \$8.7 million in 2012. We have no information on exclusions related to advanced manufacturing purchases authorized by the 2012

legislation. However, the law caps the allowable sales and use tax exclusions for both programs at \$100 million annually.

This revenue estimate does not account for any changes in economic activity that may or may not result from enactment of the proposed law.

Analysis prepared by:	Sheila T. Waters	916-445-6579	04/23/13
Revenue estimate by:	Ronil Dwarka	916-445-0840	
Contact:	Michele Pielsticker	916-322-2376	

Is 0235sb040113stw.docx

---

*This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the BOE's formal position.*



STATE BOARD OF EQUALIZATION  
PROPOSED AMENDMENTS TO SB 235

AMENDMENT 1

On page 5, line 32, add “primarily” after “is” and before “engaged”

AMENDMENT 2

On page 5, line 2, add “tangible personal” after “or” and before “property”

AMENDMENT 3

On page 7, lines 30 and 35, add “tangible personal” before “property”

AMENDMENT 4

On page 8, lines 3, 4, and 12, add “tangible personal” before “property”